

THE WRECK OF REGULATION D: THE UNINTENDED (AND BAD) OUTCOMES FOR THE SEC'S CROWN JEWEL EXEMPTIONS*

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Regulation D is—or at least should be—the crown jewel of the Securities and Exchange Commission's regulatory exemptions from the registration requirements of the Securities Act of 1933. It offers businesses—especially businesses with relatively small capital requirements—fair and efficient access to vital, external capital.

In this article, I present data derived from deep samples of recent Form Ds filed with the Commission. The data show that Regulation D is not working in the way the Commission intended or in a way that benefits society. The data reveal that companies attempting to raise relatively small amounts of capital under Regulation D overwhelmingly forego the low transaction costs of offerings under Rule 504 and Rule 505 in favor of meeting the more onerous (and more expensive) requirements of Rule 506. Additionally, these companies overwhelmingly limit their relatively small offerings to accredited investors, which dramatically reduces the pool of potential investors.

This unintended and bad outcome is the result of the burdens imposed by state blue sky laws and regulations, and this has to a large degree wrecked the sensible and balanced approach of the Commission in Regulation D.

Reclaiming Regulation D requires the elimination of state authority over all Regulation D offerings. State regulators, however, have proven to be aggressive and effective in protecting their turf. Although the Commission has the ability—and I believe the duty—to solve this problem for the benefit of the economy, it has a history of an unwillingness to take on state regulators, even in

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instances where state regulations essentially destroy the Commission's sensible and balanced regime for capital formation. Congress also could solve the problem by expanding federal preemption to cover all offerings made under Regulation D.

I. INTRODUCTION

In 1982, the Securities and Exchange Commission (SEC or Commission) adopted Regulation D,¹ which offered businesses, especially small businesses, attractive exemptions from the registration requirements of the Securities Act of 1933 (Securities Act). These exemptions were carefully crafted by the Commission and informed by the considerable experience the Commission had acquired in connection with its earlier, somewhat problematic rules—Rule 240,² Rule 242³ and Rule 146.⁴

The Commission's experience with those prior rules and some not so gentle nudging by commentators⁵ seemingly convinced the Commission that sensible and successful exemptions from the registration requirements of the Securities Act must strike an acceptable balance between investor protection and capital formation.⁶ Regulation D adopted this idea.

¹ See 17 C.F.R. §§ 230.501–.508 (2012). The rules were adopted in Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11251 (Mar. 16, 1982) (codified at 17 C.F.R. pts. 230, 239). Regulation D now consists of Rules 501 through 508. Rules 501 through 503 and Rules 507 through 508 are general rules of support for the exemptions found in Rules 504 through 506.

² 17 C.F.R. § 230.240 (1981). Rule 240 provided an exemption from registration under section 3(b) of the Securities Act of 1933, 15 U.S.C. § 77c(b) (2006), for offerings of up to \$100,000.

³ 17 C.F.R. § 230.242. Rule 242 provided an exemption from registration under section 3(b) of the Securities Act, 15 U.S.C. § 77c(b), for offerings of up to two million dollars.

⁴ 17 C.F.R. § 230.146. Rule 146 provided an exemption from registration under section 4(2) of the Securities Act, 15 U.S.C. § 77d(2), for offerings unlimited in amount.

⁵ See, e.g., Rutheford B Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139 (1978) (describing the ambiguity of Rule 146, the problems created by the integration provisions of that rule and the difficulty of reselling securities acquired in offerings exempt under Rule 146).

⁶ Former Rule 146 was especially unbalanced in this regard. *Id.* at 1143–57. Later, Congress specifically instructed the Commission regarding the obligation to balance investor protection and capital formation. 15 U.S.C. § 77b(b) (“the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation”).

With regard to investor protection, Regulation D was based on the correct assumption that the two most potent protections for investors are their own sophistication—their ability to evaluate the merits and risks of any offering of securities—and the meaningful disclosure of or access to material investment information.⁷ With regard to capital formation, Regulation D was based on the correct assumptions that transaction costs (offering costs) can throttle capital formation and that it is relative, not absolute, offering costs that are important in that regard.⁸

Regulation D, therefore, offered issuers a stair-step approach through its three exemptions—Rule 504, Rule 505 and Rule 506—requiring more investor protections as the size of the offering increased. The apparent reckoning of the Commission was that the investor protection devices—disclosure and sophistication requirements—generate significant transaction costs for issuers, and since relative rather than absolute transaction costs choke off capital formation, a sensible balance between capital formation and investor protection leads to the imposition of additional investor protection requirements as deals get larger.

Accordingly, Rule 504 provides an exemption from registration for offerings up to one million dollars⁹ without any purchaser sophistication requirement or disclosure requirement.¹⁰ Rule 505, which provides an exemption for offerings up to five million dollars, requires the issuer in most cases to disclose investment information to the purchasers.¹¹ Rule 506, which provides an exemption without any amount limitation, requires the issuer in most cases to make even more extensive disclosures of investment information¹² and generally limits purchasers to sophisticated or accredited investors.¹³

The Commission deserves high praise for its enactment of Regulation D. Even if one is unsure that each balance struck by the Commission in Regulation D was precisely correct, the underlying theory was sensible, and

⁷ See *infra* notes 9–13 and accompanying text.

⁸ *Id.*

⁹ As originally enacted, Rule 504 offered an exemption for offerings up to \$500,000. See 17

C.F.R. § 230.504(b)(2)(i) (1983).

¹⁰ 17 C.F.R. §§ 230.504(b)(iii)(2), 230.502(b)(1) (2012).

¹¹ *Id.* §§ 230.505, 230.502(b)(1). Rule 505, however, does not require disclosure of investment information in the case of sales to accredited investors. *Id.* § 230.502(b)(1).

¹² *Id.* § 230.506. Rule 506, however, does not require disclosure of investment information in the case of sales to accredited investors. *Id.* § 230.502(b)(1).

¹³ *Id.* § 230.506(b)(2)(ii).

the regulation amounts to a good-faith and generally sound application of that theory by an experienced and respected regulatory agency.¹⁴

A number of events or circumstances since 1982, however, have reshaped the environment in which Regulation D operates and as a result, have to a large extent wrecked Regulation D. Data demonstrate that small issuers raising small amounts of capital now overwhelmingly abandon Rule 504 and Rule 505. Offerings of securities eligible to use those exemptions are now by a very large majority made under Rule 506 and limited to accredited investors.¹⁵

This unintended outcome is the result of state securities laws, specifically states' registration requirements in their blue sky laws.¹⁶

In 1996, Congress enacted the National Securities Markets Improvement Act¹⁷ (NSMIA), which preempted state authority over the registration of securities offered under Rule 506.¹⁸ NSMIA did not, however, preempt state authority over offerings made under Rule 504 and Rule 505.¹⁹ It is this distinction regarding preemption of state blue sky laws that causes issuers to abandon Rule 504 and Rule 505 and restructure these

¹⁴ See Rutheford B Campbell, Jr., *The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems that Need Attention*, 74 KY. L.J. 127, 135 (1985) ("The problem with Regulation D . . . is not the underlying fundamental philosophy of the rules, but, instead, is the implementation of that philosophy.").

¹⁵ Regulation D defines "accredited investor" to include both "[a]ny natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000" and "[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year." 17 C.F.R. §§ 230.501(a)(5), (a)(6). The net worth test for an accredited investor was recently amended to exclude the value of the investor's primary residence. See *infra* note 105 and accompanying text.

¹⁶ These state laws and the regulations enacted thereunder require issuers offering their securities in a particular state either to register the securities with the state's division of securities or to meet the requirements for an exemption from the particular state's registration requirement. See, e.g., UNIF. SEC. ACT § 301, 7C U.L.A. 74 (2002) ("It is unlawful for any person to offer or sell any securities in this state unless (1) the security is a federal covered security (2) the security, transaction, or offer is exempted from registration under Section 201 through 203 (3) the security is registered under this [Act].").

¹⁷ National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C.).

¹⁸ 15 U.S.C. §§ 77r(a)(1)(A), (b)(4)(D) (2006) (amended 2012).

¹⁹ Rule 504 and Rule 505 are enacted under section 3(b) of the Securities Act. See 17 C.F.R. §§ 230.504(a), 230.505(a) (2012). Securities offered under exemptions enacted under section 3(b) are not "covered securities" and thus not subject to preemption. See 15 U.S.C. § 77r(b).

small offerings as compliant with Rule 506 and limited to accredited investors.

In short, state blue sky laws have wrecked the sensible, balanced and efficient regime that the Commission enacted in Regulation D. What is interesting and, indeed, unfortunate for small issuers and the economy generally is that the Commission, which acted so appropriately in the construction of Regulation D, has without even a whimper of protest permitted the beneficial effects of Regulation D to be largely neutralized in this manner, making it more difficult for issuers, especially small issuers, to find the capital they need to do business.

In this article I offer data demonstrating the evolution of Regulation D into a regime that the Commission neither intended nor anticipated. The data, taken from deep samples of recent Form D filings, show that issuers relying on the exemptions provided by Regulation D, no matter the size of their offering, overwhelmingly offer their securities pursuant to the terms of Rule 506 and limit their offering to accredited investors. The data demonstrate the marginalization of Rule 504 and Rule 505 and the consequent destruction of the fundamental regime originally constructed by the Commission in Regulation D.

This is, I argue, an unintended outcome and, even more importantly, a bad outcome. Small businesses are a vital part of our national economy and face formidable structural and economic obstacles when they search for external capital. It is unfair and bad national policy to allow state blue sky laws effectively to foreclose or significantly limit these businesses and entrepreneurs from efficient access to external capital. Indeed, such an outcome is also inconsistent with the articulated congressional preference for capital formation rules that sensibly balance investor protection and capital formation.²⁰

To reclaim Regulation D, the Commission must more closely monitor the vast data available to them in Form Ds filed by issuers utilizing Regulation D. Such oversight is essential if sensible adjustments in the regulation are to be made as conditions change. The Commission must also have the courage to take the affirmative action to neutralize the pernicious effects on Regulation D caused by state blue sky laws.

²⁰ As a part of NSMIA, Congress specifically ordered the Commission to follow such a balanced approach in instances when the Commission's delegated authority to enact rules was to be exercised in furtherance of the "public interest." See 15 U.S.C. § 77b(b) ("Whenever . . . the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.").

II. OVERVIEW OF REGULATION D

In 1974, the Commission adopted Rule 146²¹ and thus began a decade of regulatory activity regarding what roughly may be called private placements.²² Rule 146, however, was an inauspicious beginning for the Commission.²³ The Rule's requirements were so burdensome and expensive that the exemption was often practically unavailable, especially for small offerings by small issuers.²⁴

Responding to the special problems that small businesses had in meeting the conditions of Rule 146, the Commission in 1975 adopted Rule 240, which offered an exemption from registration to small companies selling up to \$100,000 of their securities.²⁵ Then, in 1978, the Commission

²¹ Rule 146 was adopted by the Commission in Transactions by an Issuer Deemed Not to Involve Any Public Offering, Securities Act Release No. 5487, 4 SEC Docket 154 (Apr. 23, 1974). The rule became effective June 10, 1974.

²² Prior to the adoption of Rule 146, private placements were limited to offerings under the common law that had developed around section 4(2) of the Securities Act. Although the exemption provided by section 4(2) of the Securities Act was widely utilized by issuers prior to the Commission's administrative rules regarding private offerings, the exemption was widely criticized for its ambiguity. *See, e.g.,* Royall Victor, Jr. & Melvin L. Bedrick, *Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869, 869 (1959) (characterizing section 4(2) as "probably the most frequently used of all the exemptions, either consciously or unconsciously"); *see also* Edward T. McDermott, *The Private Offering Exemption*, 59 IOWA L. REV. 525, 549 (1974) (characterizing the exemption as "a tale of growing confusion"); Julian M. Meer, *The Private Offering Exemption Under the Federal Securities Act—A Study in Administrative and Judicial Contraction*, 20 SW. L.J. 503, 534 (1966) (characterizing use of the exemption for non-institutional offerees as "a hazardous risk").

²³ *See* Homer Kripke, *SEC Rule 146: A "Major Blunder,"* N.Y. L.J. (July 5, 1974), at 1, col. 2; Robert A. Kessler, *Private Placement Rules 146 and 240—Safe Harbor?*, 44 FORDHAM L. REV. 37 (1975); Robert H. Kinderman, Jr., *The Private Offering Exemption: An Examination of Its Availability Under and Outside Rule 146*, 30 BUS. LAW. 921 (1975); Ellsworth A. Weinberg & Michael W. McManus, *The Private Placement Exemption Under the Securities and Exchange Act of 1933 Revisited, and Rule 146*, 27 BAYLOR L. REV. 201 (1975); H. David Heumann, *Is Rule 146 Too Subjective to Provide the Needed Predictability in Private Offerings?*, 55 NEB. L. REV. 1, 9 (1975).

²⁴ *See* Campbell, *supra* note 5, at 1143–57.

²⁵ *See* 17 C.F.R. § 230.240 (1976). Rule 240 was adopted in Exemption of Certain Limited Offers and Sales by Closely Held Issuers, Securities Act Release No. 5560, 6 SEC Docket 132 (Jan. 24, 1975). In the adopting release, the Commission stated that the exemption was for small issuers "where, because of the small size and limited character of the offering, the public benefits of registration are too remote." *Id.* at 132.

enacted Rule 242,²⁶ which provided an exemption from registration for offerings up to \$500,000. The requirements for a Rule 242 exemption were more onerous than those of Rule 240, but significantly less burdensome (and expensive) than the requirements of Rule 146.²⁷

In 1982, the Commission adopted Regulation D.²⁸ The new regulation amounted to a consolidated and much improved version of those prior three rules. Roughly, new Rule 504, Rule 505 and Rule 506 replaced, respectively, old Rule 240, Rule 242 and Rule 146.

Today's Regulation D differs little from the original version of that regulation adopted in 1982.²⁹ Over the nearly thirty-year history of Regulation D, the Commission has held to its fundamental underlying principle of balancing investor protection and capital formation, continuing to recognize that relatively high transaction costs can choke off valuable capital formation.

Briefly, today's Rule 504 exemption, which is limited to non-reporting companies, permits a non-1934 Act company to offer up to one million dollars in securities in a twelve-month period.³⁰ There are no disclosure requirements or offeree or purchaser qualification requirements. The Rule imposes no limitation on the number of purchasers that may acquire securities in a Rule 504 offering. The issuer is prohibited from engaging in

²⁶ See 17 C.F.R. § 230.242 (1980). Rule 242 was adopted in Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act Release No. 6180, 19 SEC Docket 295 (Jan. 17, 1980).

²⁷ For example, unlike the requirements of Rule 240, the exemption provided by Rule 242 required disclosure of investment information (in addition to other requirements). 17 C.F.R. § 230.242(c)–(h) (1979).

²⁸ Today's version of Regulation D is found at 17 C.F.R. §§ 230.501–.508 (2012). In early 1978, the Commission announced the hearings that led to the adoption of Regulation D. Securities Act Release No. 5914, 43 Fed. Reg. 10,876 (Mar. 15, 1978). Regulation D became effective on April 15, 1982. See Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11251, 11251 (Mar. 16, 1982).

²⁹ There are, of course, some differences. For example, as originally adopted, Rule 504 provided an exemption only for offerings of up to \$500,000, while today that limit has been raised to one million dollars. Compare 17 C.F.R. § 230.504(b)(2)(i) (1983), with 17 C.F.R. § 230.504(b)(2)(i) (2012). Also, for example, as originally adopted, one of the accredited investor standards was based on “individual income in excess of \$200,000,” while today that test has been expanded to include a test based on one’s “joint income with that person’s spouse in excess of \$300,000.” Compare 17 C.F.R. § 230.501(a)(7) (1983), with 17 C.F.R. § 230.501(a)(6) (2012). Also, the net worth standard for an accredited investor has recently been amended. See *infra* note 105 and accompanying text. But, as the following textual discussion demonstrates, the fundamental requirements and, most certainly, the philosophy of Regulation D have been unchanged over that period.

³⁰ 17 C.F.R. § 230.504(b)(2) (2012).

any general advertising in connection with the offering and must take steps to ensure that there is no public resale of the securities for a period of time.³¹

Rule 505, which is available to both reporting and non-reporting companies, offers issuers an exemption for offerings of up to five million dollars, but it conditions the availability of the exemption on the issuer's meeting additional conditions, the most significant of which is the requirement that the issuer, prior to sale, provide each unaccredited purchaser with a significant amount of closely prescribed narrative and financial investment information.³² An additional condition in Rule 505, as compared to Rule 504, is a limit of thirty-five unaccredited purchasers.³³ Similar to Rule 504, Rule 505 prohibits any general advertising of the offering and requires that the issuer take steps to prevent any public resale of the securities acquired in a Rule 505 offering.³⁴

Rule 506 is available to reporting and non-reporting companies and imposes no amount limitation on the issuer's offering.³⁵ Like Rule 505, it predicates the availability of the exemption on the issuer's supplying a closely prescribed narrative and financial investment information to all unaccredited purchasers, and the amount of this information increases as the size of the offering gets larger.³⁶ Rule 506, however, enhances the required investor protection, as compared to Rule 505, by requiring that each purchaser be either sophisticated or accredited.³⁷ Like Rule 505, Rule 506 prohibits general advertising, requires that the issuer take steps to prevent any public resales of the securities acquired in a Rule 506 offering and limits the number of unaccredited purchasers to thirty-five.³⁸

To reiterate, the underlying theory of Regulation D—imposing additional investor protection requirements as transactions get larger—makes perfect sense as an appropriate balance of the important, competing policies of promotion of capital formation and investor protection.³⁹ Certainly it was rational at the time of adoption to anticipate that Regulation D would work as planned—that small offerings would utilize Rule 504, that somewhat larger offerings would utilize Rule 505 and that the largest private offerings would utilize Rule 506. Regulation D appeared to offer a strong incentive for small issuers—and there are literally millions of them

³¹ *Id.* § 230.504(b)(1).

³² *Id.* § 230.505(b).

³³ *Id.* § 230.505(b)(2)(ii).

³⁴ *Id.* § 230.505(b)(2)(iii).

³⁵ *See* 17 C.F.R. § 230.506 (2012).

³⁶ *Id.* § 230.506(b)(1).

³⁷ *Id.* § 230.506(b)(2)(ii).

³⁸ *Id.* § 230.506(b).

³⁹ *See supra* notes 7–8 and accompanying text.

with needs for external capital⁴⁰—to flock to Rule 504, with its minimal requirements and the resulting low transaction costs. For the same reasons—relatively lower transaction costs—it was rational to assume that small issuer offerings of one million to five million dollars would utilize Rule 505 instead of Rule 506. The economic incentives built into Regulation D seemed certain to ensure that the stepped approach of Regulation D would work in a manner consistent with the Commission's obligation to offer exemptions from registration that balance the need for investor protection with the need to encourage capital formation.

As the next part of this article demonstrates, however, the actual outcome has been dramatically different from the Commission's intended outcome and its obligation to promote capital formation with its rules.

III. DATA: THE WRECK OF THE COMMISSION'S REGULATION D EXEMPTIONS

Data demonstrate the failure of Regulation D to achieve the Commission's goals, especially the goal of promoting efficient capital formation for small businesses.

A. The Marginalization of Rule 504 and Rule 505

Tables I through IV, which follow, provide data from approximately 27,000 Form Ds filed between September 15, 2008 and October 18, 2010.⁴¹ Data from this deep sample of Form Ds show that Regulation D offerings overwhelmingly are made under Rule 506. Even offerings of one million dollars or less—offerings that are suited for Rule 504—are overwhelmingly made under Rule 506. Similarly, the data show offerings of one million to five million dollars—offerings that are suited for Rule 505—are also overwhelmingly made under Rule 506.

Consider first Table I, immediately below, which shows the percentage and number of Regulation D offerings in our sample that were made under Rule 504, Rule 505 and Rule 506.

⁴⁰ See *infra* notes 43–46 and accompanying text.

⁴¹ Regulation D data were obtained from the subscription-only Knowledge Mosaic website. See Form D Data, KNOWLEDGE MOSAIC, www.knowledgemosaic.com (last visited Oct. 30, 2012) (follow “Form D” hyperlink; then search “Form D”). Form D filings claiming multiple Regulation D exemptions were not included in the data reported in this article.

Table I

	Regulation D Offerings Under Rule 504	Regulation D Offerings Under Rule 505	Regulation D Offerings Under Rule 506
Percentage	4.4%	1.6%	94.0%
Number	1196/27,234	447/27,234	25,591/27,234

Combined, offerings under Rule 504 and Rule 505 amounted to a mere 6% of all Regulation D offerings, and upon first consideration, this modest use of Rule 504 and Rule 505 and the overwhelming reliance on Rule 506 seem curious. The data in Table I become even more difficult to understand in light of the number of small businesses in this country and the need these firms have for external capital.

Data from the Small Business Administration (SBA),⁴² for example, show that there are nearly five million businesses in the United States that employ fewer than twenty individuals.⁴³ This amounts to almost 90% of the total business units in the United States.⁴⁴ SBA data⁴⁵ also indicate that nearly 5,500,000 business firms have fewer than one hundred employees, which amounts to slightly over 98% of the total business units in the United States.⁴⁶ It is, of course, these millions of small businesses that were the intended beneficiaries of the Commission's Rule 504 and Rule 505.

Not surprisingly, the data indicate that these smaller firms require external capital in order to compete in the marketplaces in which they

⁴² See, e.g., U.S. SMALL BUS. ADMIN., THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1999-2000 (2001) [hereinafter THE STATE OF SMALL BUSINESS 2000]. Earlier SBA data do not differ materially from later data. See, e.g., U.S. SMALL BUS. ADMIN., THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1994 (1995) [hereinafter THE STATE OF SMALL BUSINESS 1994].

⁴³ THE STATE OF SMALL BUSINESS 2000, *supra* note 42, at 61 tbl.A.4 (in 1998, 4,988,367 firms in America had fewer than twenty employees).

⁴⁴ See *id.* (in 1998, 89.4% of all firms in America had fewer than twenty employees).

⁴⁵ Data demonstrating the significance of small business to our economy can also be found in U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 1999, at 545 tbl.861 (119th ed. 1999) (84.6% of all business tax returns filed for 1980 were filed by entities with less than one million dollars in receipts); *id.* at 555 tbl.874 (in 1980, 22.3% of total national payroll came from firms with fewer than twenty employees, and 47.5% of total national payroll that year came from firms with fewer than one hundred employees).

⁴⁶ See THE STATE OF SMALL BUSINESS 2000, *supra* note 42, at 61 tbl.A.4 (in 1998, firms employing fewer than one hundred employees accounted for 98.3% of all firms in the United States).

operate. For example, approximately 90% of small firms rely on external debt for financing.⁴⁷

A closer look at the data from our sample of Form Ds, however, demonstrates that smaller firms are indeed utilizing Regulation D for their small capital requirements.

Consider in that regard Table II, immediately below, which groups Regulation D offerings by size. Table II shows both the percentage and number of Regulation D offerings from our sample that were one million dollars or less and the percentage and number of Regulation D offerings that were between one million and five million dollars.

Table II

	Regulation D Offerings of \$1 Million or Less	Regulation D Offerings of \$1 Million to \$5 Million
Percentage	28.9%	25.9%
Number	7880/27,234	7059/27,234

Table II indicates that approximately 55% of the Regulation D offerings in our 27,000 sample were for amounts of five million dollars or less. Offerings of one million dollars or less—offerings that were within the Rule 504 permissible range—accounted for approximately 29% of the Regulation D offerings in our sample, and offerings of one million to five million dollars—offerings that were within the Rule 505 permissible range—accounted for approximately 26% of the Regulation D offerings in our sample.

Tables III and IV reconcile what appear to be inconsistent data from Tables I and II, demonstrating that issuers offering securities under Regulation D in the permissible ranges of Rule 504 and Rule 505 overwhelmingly effected those offerings under Rule 506.

Table III shows the percentage and number of Regulation D offerings of one million dollars or less that were made under Rule 504 and Rule 506.

⁴⁷ See THE STATE OF SMALL BUSINESS 1994, *supra* note 42, at 167 tbl.5.15 (in 1993, 88.7% of firms with ten to nineteen employees and 91.1% of firms employing between twenty and ninety-nine persons relied on external credit as a form of financing).

Table III

	Regulation D Offerings of \$1 Million or Less Offered Under Rule 504	Regulation D Offerings of \$1 Million or Less Offered Under Rule 506
Percentage	14.3%	78.6%
Number	1125/7880	6196/7880

The data in Table III show that small issuers offering small amounts of securities under Regulation D overwhelmingly abandoned Rule 504, which is the Regulation D exemption especially formulated by the Commission to provide fair and efficient access to capital for small businesses. Instead, these small issuers by a large majority relied on Rule 506, with its more onerous and expensive offering requirements.

Table IV shows the percentage and number of Regulation D offerings between one million and five million dollars that were made under Rule 505 and Rule 506.

Table IV

	Regulation D Offerings of \$1 Million to \$5 Million Offered Under Rule 505	Regulation D Offerings of \$1 Million to \$5 Million Offered Under Rule 506
Percentage	3.9%	91.9%
Number	276/7059	6487/7059

The data demonstrate, once again, that smaller companies fail to take advantage of the low transaction costs of Rule 505. As was the case with offerings of one million dollars or less, these small businesses overwhelmingly rely on Rule 506, with its more onerous and expensive offering requirements.

B. Regulation D Offerings Limited to Accredited Investors

Tables V through VIII, which are based on a sample of 1000 Form D filings made between September 15, 2010 and October 12, 2010,⁴⁸ show that Regulation D has largely become an exemption under which offerings

⁴⁸ A sample of 1000 Regulation D filings was obtained from SEC filings in September and October of 2010. See Form D Data, KNOWLEDGE MOSAIC, <http://www.knowledgemosaic.com> (last visited Oct. 30, 2012) (follow "Form D" hyperlink; then search "Form D"; then search Filing Date Range beginning on 9/15/2010 and ending on 10/12/2010). The manner in which Knowledge Mosaic collected and grouped the Form D data regarding accredited investors, Tables V–VIII, and financial intermediation, Table IX, made it practically impossible to use the approximately 27,000 sample used in Tables I–IV.

are made exclusively to accredited investors. Most important for this article is Table VIII, which shows that issuers offering a small amount of securities under Regulation D (offerings in amounts that could take advantage of Rule 504 and Rule 505) are overwhelmingly limiting their search for external capital to accredited investors.

Table V, immediately below, shows the percentage and number of all Regulation D offerings in our sample that were made exclusively to accredited investors.

Table V

Regulation D Offerings Limited to Accredited Investors	
Percentage	88.5%
Number	885/1000

Table VI provides additional information about the Regulation D offerings in Table V, separating those offerings into offerings made under Rule 504, Rule 505 and Rule 506.

Table VI

	Rule 504 Offerings Limited to Accredited Investors	Rule 505 Offerings Limited to Accredited Investors	Rule 506 Offerings Limited to Accredited Investors
Percentage	59.3%	56.5%	91.2%
Number	35/59	13/23	837/918

Table VI, however, does not accurately reflect the extent to which small offerings are limited to accredited investors. This is because, as described earlier in connection with the data in Table III and Table IV, a large percentage of the offerings within the range of Rule 504 (one million dollars or less) and the range of Rule 505 (one million to five million dollars) are made under Rule 506.

Table VII shows that these smaller offerings made under Rule 506 are overwhelmingly limited to accredited investors.

Table VII

	Offerings of \$1 Million or Less Made Under Rule 506 and Limited to Accredited Investors	Offerings of \$1 Million to \$5 Million Made Under Rule 506 and Limited to Accredited Investors
Percentage	88.3%	91.8%
Number	203/230	191/208

Table VIII combines the information from Tables VI and VII. Table VIII shows the percentage and number of offerings of one million dollars or less that were limited to accredited investors and the percentage and number of offerings of between one million and five million dollars that were limited to accredited investors.

Table VIII

	All Regulation D Offerings of \$1 Million or Less Limited to Accredited Investors	All Regulation D Offerings of \$1 Million to \$5 Million Limited to Accredited Investors
Percentage	82.4%	88.3%
Number	238/289	204/231

Table VIII shows most vividly the extent to which small businesses searching for relatively small amounts of external capital limit their search to accredited investors only.

C. Financial Intermediation in Regulation D Offerings

Data from our sample of Form Ds provide a final important insight into the access to external capital by issuers with limited capital needs. The data demonstrate the difficulty these small offerings face in attracting financial intermediation—the professional assistance from brokers or underwriters that issuers need to sell their securities.

Table IX provides information from our sample showing that in a large majority of cases, issuers raising small amounts of capital under Regulation D do not use financial intermediation.⁴⁹

As discussed below,⁵⁰ the data in Table IX reflect in their own way the special need that small entrepreneurs have for regulatory rules that efficiently and fairly facilitate their access to external capital.

⁴⁹ Table IX does not show data regarding financial intermediation in Regulation D offerings of more than five million dollars. The author was uncertain about the reliability of the data taken from the Form Ds on these offerings. Examining the data suggests that a significant percentage of those offerings were Rule 144A offerings, in which the purchaser was purchasing from the issuer with the view of reselling into the institutional market. It was uncertain whether in such circumstances the issuer was reporting that it paid a commission. Nonetheless, based on the same sample used for Table VI, 13.8% of Regulation D offerings of more than five million dollars (62/448) were made with assistance of financial intermediation.

⁵⁰ See *infra* notes 66–67 and accompanying text.

Table IX

	Regulation D Offerings of \$1 Million or Less with Financial Intermediation	Regulation D Offerings of \$1 Million to \$5 Million with Financial Intermediation
Percentage	5.8%	12.7%
Number	18/308	31/244

IV. THE DATA: INTERPRETATIONS, INFERENCES AND CONCLUSIONS

A. *The Underuse of Rule 504 and Rule 505: Limiting Offerings to Accredited Investors*

The most obvious interpretation of the data in Part III of this article is that Regulation D has failed to achieve the Commission's goals of providing entrepreneurs with relatively small capital requirements and a balanced and efficient path to external capital. Companies able to meet the conditions for the exemptions provided by Rule 504 or Rule 505—and there are millions of them⁵¹—overwhelmingly abandon those rules as a basis for meeting their obligations under the Securities Act. Instead, the companies elect to comply with the requirements of Rule 506, even though meeting the conditions of that exemption is more onerous and expensive. These companies also, once again overwhelmingly, limit their capital search to accredited investors, who amount to a small fraction of the population.⁵²

The data for offerings of one million dollars or less (offerings that should fit under Rule 504) show that 78.6% are made under Rule 506, and 82.4% are limited to accredited investors. For offerings of between one million and five million dollars (offerings that should fit under Rule 505), data show that 91.9% of those offerings are made under Rule 506, and 88.3% of those offerings are limited to accredited investors.

B. *Why Companies Abandon Rule 504 and Rule 505 and Limit Offerings to Accredited Investors*

Typically, companies eligible to use Rule 504 and Rule 505 face tough circumstances when they seek external capital. As a result of their size and

⁵¹ See *supra* notes 43–47 and accompanying text.

⁵² For example, data from the Internal Revenue Service show that in 2007 only 3.172% of all tax returns reported an annual adjusted gross income of \$200,000 or more. See Justin Bryan, *High-Income Tax Returns for 2007*, STAT. INCOME BULL., Spring 2010, at 4.

the small amounts of capital they seek to raise, their offerings are difficult and expensive.⁵³ Financial intermediation is likely to be unavailable,⁵⁴ and relative transaction costs for these companies are high.⁵⁵ Why, then, would such companies opt out of the benefits of what appear to be lower transaction costs associated with an offering under Rule 504 or Rule 505 in favor of the apparently higher transaction costs associated with offerings under Rule 506? And further, why would such companies significantly limit the pool of potential investors by offering only to accredited investors?

The most obvious explanation is that altering the terms and techniques of the offerings in order to meet the requirements of Rule 506 and limiting the offerings to accredited investors solve the issuers' state securities problems.

Imagine, for example, a small company that proposes to raise one million dollars by offering its securities in three states. Meeting the requirements of Rule 504 is rather simple in that case. Essentially the rule only requires that the issuer engage in no general advertising and restrict the resale of its securities that are acquired in the Rule 504 offering.⁵⁶ The issuer, however, must also meet the registration requirements in each of the three states in which it offers its securities. Thus the issuer faces three additional, distinct sets of rules respecting the offering of its securities. It also faces the residual risk that it might inadvertently fail to meet the requirements of one of the states, generating significant potential liability.

One way to meet its burdens under state laws is for our issuer to restructure the offering under Rule 506, since NSMIA preempted state authority over Rule 506 offerings.⁵⁷

⁵³ See Rutheford B Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 88–90 (2006) (describing structural and economic impediments to small business capital formation).

⁵⁴ See *supra* Table IX.

⁵⁵ See Campbell, *supra* note 53, at 89 (describing why offering expenses for small businesses are "very high").

⁵⁶ Rule 504 incorporates by reference only sections (a), (c) and (d) of Rule 502. See 17 C.F.R. § 230.504 (2012); see also 17 C.F.R. § 230.502(a), (c)–(d). Section (a) of Rule 502 offers a safe harbor from integration; (c) prohibits general advertising; and (d) imposes restrictions on the resale of securities taken in a Rule 504 offering. *Id.* Recent amendments to the resale provisions of Rule 144 shortened the holding period for shares taken under Regulation D to six months or one year, depending on the circumstances. 17 C.F.R. § 230.144(d)(1)(i)–(ii); see also Rutheford B Campbell, Jr., *Resales of Securities: The New Rules and the New Approach of the SEC*, 37 SEC. REG. L.J. 317, 325–27 (2009) (discussing resales under the recently amended Rule 144 for shares acquired under Regulation D).

⁵⁷ Section 18 of the Securities Act, 15 U.S.C. § 77r (2006) (amended 2012) (preempting state authority over offerings of "covered securities," which term

Moving to Rule 506, however, generates additional burdens on the issuer. Most important, under Rule 506 the issuer is generally required to provide prescribed disclosures to purchasers, ensure that sales are made only to qualified investors and limit its sales to thirty-five purchasers.⁵⁸ These requirements significantly complicate a Rule 506 offering and raise transaction costs for issuers.

All three of these additional requirements, however, are met if the offering is limited to accredited investors. Rule 506 imposes no disclosure in connection with sales to accredited investors.⁵⁹ The purchaser qualification requirements of the rule are met if purchasers are accredited investors,⁶⁰ and there is no limit on the number of accredited investors under Rule 506.⁶¹

These are the reasons that roughly 80% of all offerings in the size range that would qualify for Rule 504 or Rule 505 are made under Rule 506 and limited to accredited investors.⁶²

Issuers rationally conclude that an offering under Rule 506 limited to accredited investors involves lower transaction costs than offerings under Rule 504 and Rule 505, which are required to meet the registration provisions under each state's blue sky laws.

C. Pernicious Effects

The effective loss of, or material limitation on, the availability of Rules 504 and 505 is pernicious. Although the harm falls most directly on small businesses, the economy as a whole loses when small businesses are limited in their access to external capital.

Small businesses are a vital part of our national economy. Data available from the Small Business Administration show, for example, that approximately 18% of all employment in the United States is provided by firms with fewer than twenty employees,⁶³ and approximately 36% of

includes securities offered in transactions exempt under "Commission rules or regulations issued under [section 4(2)]" of the Securities Act).

⁵⁸ 17 C.F.R. §§ 230.506(b)(2), 230.502 (2012).

⁵⁹ *Id.* § 230.502(b)(1).

⁶⁰ *Id.* § 230.506(b)(2)(ii).

⁶¹ *Id.* § 230.501(e)(1)(iv).

⁶² See *supra* Tables III, IV, VII & VIII.

⁶³ See U.S. SMALL BUS. ADMIN., THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 2004, 178 tbl.A.5 (2004) [hereinafter THE STATE OF SMALL BUSINESS 2004] (in 2001, 17.9% of all employment was provided by firms with fewer than twenty employees); see also THE STATE OF SMALL BUSINESS 2000, *supra* note 42, at 61 tbl.A.4 (in 1998, 18.8% of all employment was provided by firms with fewer than twenty employees).

employment is provided by firms with fewer than one hundred employees.⁶⁴ Thoughtful commentary has opined that even these numbers understate the importance of small businesses to the vitality of our national economy.⁶⁵

In securing essential external capital,⁶⁶ small businesses face significant impediments. First are the structural or marketplace impediments. No—or very limited—financial intermediation is available for small offerings. Consider the data in Table IX, for example, showing that only 5.8% of all offerings of one million dollars or less are made through brokers or other financial intermediaries. The reason for this is that small deals by unseasoned issuers generate expenses that swamp the value created by the transactions. Brokers representing small deals face the costs of learning the deal, effecting the necessary offers and sales, and absorbing the residual legal risks. Small offerings cannot support such expenses.

The absence of financial intermediation puts these smaller companies at a significant disadvantage. The issuers, one might assume, are efficient in their own business (e.g., making widgets) but not in selling securities. They maintain no professional staff with the necessary skills to raise capital by selling securities. Professors Gilson and Kraakman have written thoughtfully regarding the importance and efficiencies of financial intermediation.⁶⁷

In addition, small businesses' access to external capital is significantly impeded by state and federal regulatory schemes that discriminate against small entrepreneurs. Considered together, federal and state laws and regulations leave small entrepreneurs with extremely limited options regarding capital formation activities.

In other articles, I have attempted to demonstrate the limited legal options available to small issuers.⁶⁸ Briefly stated, high offering costs⁶⁹

⁶⁴ See THE STATE OF SMALL BUSINESS 2004, *supra* note 63, at 178 tbl.A.5 (firms of this size in 2001 provided work for 35.6% of all employees). In 1998, these firms provided employment for 36.7% of all employees. THE STATE OF SMALL BUSINESS 2000, *supra* note 42, at 61 tbl.A.4.

⁶⁵ See Campbell, *supra* note 53, at 85–86 (providing data and commentary from others regarding job creation and innovation by small businesses and minority ownership of small businesses).

⁶⁶ See *id.* at 87–89 (providing data and offering explanations for why traditional debt financing is attractive to small businesses).

⁶⁷ Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613–21 (1984).

⁶⁸ Campbell, *supra* note 5; Campbell, *supra* note 14; Campbell, *supra* note 53, at 100–12.

⁶⁹ See, e.g., JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 156 (6th ed. 2009) (reporting that “estimated 2007 costs for a significant IPO [include] . . . \$600,000–\$800,000 in fees to counsel, \$500,000–

generally prevent small issuers from raising their external capital through registered offerings of their securities.⁷⁰ Regulation A offerings have fallen into nearly total disuse,⁷¹ due principally to the impact of state blue sky laws.⁷² Offerings under section 4(2)⁷³ are limited to sophisticated offerees and purchasers⁷⁴ and apparently require access to or disclosure⁷⁵ of the same information that would be required in a registration statement.⁷⁶ The costs of meeting these conditions for the section 4(2) exemption and, importantly, the residual risk that an offering may not meet these nebulous requirements make section 4(2) offerings generally unattractive or unworkable for small issuers seeking external capital. Finally, offerings under the intrastate exemption provided by Rule 147⁷⁷ are restricted to a single state,⁷⁸ which inhibits any broad search for capital. Although within the single state, federal rules permit an issuer relying on Rule 147 to solicit broadly for investors,⁷⁹ coordinating an intrastate offering with state blue

\$600,000 for the auditor, underwriter commission of typically 7 percent . . . , \$150,000–\$200,000 in printing costs”).

⁷⁰ See Campbell, *supra* note 53, at 91–92. SBA data report that between 1988 and 1997, the number of IPOs by small business in those years varied between 83 and 304. In one year, 1999, there were, for example, 101 registered offerings by small businesses. THE STATE OF SMALL BUSINESS 2000, *supra* note 42, at 27 tbl.1.10.

⁷¹ See Campbell, *supra* note 53, at 83 (“from 1995 through 2004” the Commission received an average of “only about eight Regulation A filings per year”).

⁷² *Id.* at 106–10.

⁷³ For a good explanation of the common law of section 4(2), see COMM. ON FED. REGULATION OF SEC., ABA SECTION OF BUS. LAW, LAW OF PRIVATE PLACEMENTS (NON-PUBLIC OFFERINGS) NOT ENTITLED TO BENEFITS OF SAFE HARBORS—A REPORT, 66 BUS. L. 85 (2010) [hereinafter LAW OF PRIVATE PLACEMENTS].

⁷⁴ See *id.* at 96 (“Courts generally take the view that investors in private placements should have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment.”).

⁷⁵ See *Doran v. Petrol. Mgmt. Corp.*, 545 F.2d 893, 897 (5th Cir. 1977) (“We hold that in the absence of findings of fact that each offeree had been furnished information about the issuer that a registration statement would have disclosed or that each offeree had effective access to such information . . . the district court erred in concluding that the offer was a private placement.”).

⁷⁶ In *Securities & Exchange Commission v. Ralston Purina Co.*, 346 U.S. 119, 125–27 (1953), the Supreme Court, in concluding that the exemption under section 4(2) was not available for Ralston’s offering of its securities, stated that the offerees and purchasers in the transaction “were not shown to have access to the kind of information which registration would disclose.” For a discussion of how courts have interpreted this statement, see LAW OF PRIVATE PLACEMENTS, *supra* note 73, at 103–04.

⁷⁷ 17 C.F.R. § 230.147 (2012).

⁷⁸ *Id.* § 230.147(d) (offerees and purchasers must be a resident of the same state in which the issuer is incorporated and doing business).

⁷⁹ The Commission imposes no objection to a wide solicitation, even in cases where the advertisement reaches across state borders. In such interstate

sky laws will almost certainly foreclose any broad solicitation, even within the particular state.⁸⁰

Facing, as small entrepreneurs do, such difficulties in raising external capital, the pernicious effects of the loss of or material limitation on the availability of Rule 504 and Rule 505 are exaggerated. When options are so severely limited for this vital part of our national economy, any loss of an opportunity to access external capital in a cost efficient way is important.

To its credit, however, the Commission has mitigated the impact of state regulation by maintaining a low threshold for “accredited investor” status. As originally adopted in 1982, an accredited investor included one with a net worth of one million dollars and included one with an annual income of \$200,000. Those thresholds for accredited investor status essentially remained unchanged for nearly thirty years.⁸¹ During that time, of course, inflation’s impact and other economic forces significantly increased the number of persons that met one of those standards. What may be the most vivid way to see the expansionary impact of holding the accredited investor criteria constant⁸² is to consider data from the Internal

advertisements, however, the advertisement must state that the offering is limited to the state in which the intrastate offering is made. *See, e.g.*, Securities Act Release No. 4434, Fed. Sec. L. Rep. (CCH) ¶ 2270, 2609 (Dec. 6, 1961); *see also* Maryland Inn, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 97 (Jan. 21, 1976) (interstate newspaper advertisements for a Maryland intrastate offering did render Rule 147 unavailable); Master Fin., Inc., SEC No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,560 (May 27, 1999) (the fact that an out-of-state resident reads or listens to the advertisement for the intrastate offering does not disqualify the use of Rule 147).

⁸⁰ The most likely state exemption relied on for an intrastate offering is the small offering exemption. *See, e.g.*, UNIF. SEC. ACT § 402(b)(9), 7C U.L.A. 106 (2002) (limiting the offering to ten offerees, although particular states are likely to have altered the model act provision); *see also, e.g.*, KY REV. STAT. ANN. § 292.410(1)(i)(3)(b)–(c) (2010) (limiting the offering to “not more than fifteen (15) purchasers in Kentucky . . . plus an unlimited number of purchasers who are ‘accredited investors’”).

⁸¹ The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), changed the net worth standards for an accredited investor by excluding from the net worth calculation “the value of the primary residence” of the investor. *Id.* § 413(a), 124 Stat. at 1577 (to be codified at 15 U.S.C. § 77b). The effect of this is to raise the threshold for one’s accredited investor status under the net worth test of 17 C.F.R. § 230.501(a)(6) (2012). The Commission recently sought comments regarding its proposed implementation of this law. *See* Net Worth Standards for Accredited Investors, Securities Act Release No. 9177, 76 Fed. Reg. 5307 (proposed Jan. 31, 2011).

⁸² Another way to look at the impact of holding the accredited investor definition constant over the time period is in reference to the change in the consumer price index. For example, SBA data, using 1982–1984 as the base of 100, calculate the consumer price index for 2008 at 215.2. *See* U.S. SMALL BUS. ADMIN., THE STATE

Revenue Service regarding high income tax returns. Those data show that in 1982, 169,367 returns with adjusted gross income of \$200,000 or more were filed, which amounted to 0.178% of all returns.⁸³ In 2007, the number of returns with adjusted gross income of \$200,000 or more had grown to 4,535,632, or 3.172% of all returns.⁸⁴

The impact of the Commission's extremely benign neglect is that small issuers driven to Rule 506 offerings by burdensome state regulatory schemes have a larger population of potential investors. As described earlier, small offerings that migrate to Rule 506 must, as a practical matter, be limited to accredited investors.⁸⁵ As a result, the Commission's sensible inaction of allowing the pool of accredited investors to expand makes perfect sense. It is a rational, if less than perfect, response to the pernicious effects of state regulation on small business capital formation.

V. THE PRESCRIPTION

A. *History of the Problem*

State blue sky laws have been the undoing of Regulation D. In order to offer a sensible remedy for this bad and unintended outcome, it is helpful to consider the history of the relationship between state and federal regulation of capital formation.

When Congress enacted the Securities Act, it chose not to preempt state authority over the offer and sale of securities.⁸⁶ As a result, a public offering of securities in fifty states, for example, was obliged to meet the laws and regulations of fifty-one separate jurisdictions, each with its own independent, idiosyncratic rules respecting capital formation. This

OF SMALL BUSINESS: A REPORT TO THE PRESIDENT 2009, 16 tbl.1.2 (2009) [hereinafter THE STATE OF SMALL BUSINESS 2009].

⁸³ See Bryan, *supra* note 52, at 4.

⁸⁴ See *id.* Obviously, this IRS data is not a perfect fit for the accredited investor criteria of Regulation D. The IRS data report all returns with income of \$200,000 or more, not distinguishing between single and joint returns. *Id.* Rule 501(a)(6), on the other hand, defines accredited investor to include a person with "an individual [annual] income in excess of \$200,000 . . . [or a] joint income with that person's spouse in excess of \$300,000." 17 C.F.R. § 230.501(a)(6).

⁸⁵ See *supra* notes 59–61 and accompanying text.

⁸⁶ Securities Act of 1933, 15 U.S.C. § 77a, 77r. For a discussion of the history of the relationship between state and federal regulation of securities offerings, see Rutheford B Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553, 554–56 (1985); Rutheford B Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L.Q. 407, 409–11 (2000) [hereinafter Campbell, *The Insidious Remnants*].

regulatory result was a wildly expensive, wasteful⁸⁷ and multi-faceted regime that was especially burdensome and unfair for small issuers, since, as described earlier, small businesses encountered very high relative transaction costs and generally sought external capital without financial intermediation.⁸⁸

In the mid-1990s, Congress began looking at this problem. The result was the introduction of the Capital Markets Deregulation and Liberalization Act of 1995 (the Capital Markets Bill),⁸⁹ which would have preempted virtually all state authority over the offer and sale of securities. Essentially, under the Capital Markets Bill as originally introduced, states were left only with the authority to enforce state antifraud provisions and to regulate offers and sales of securities offered under the federal intrastate exemption.⁹⁰

Not surprisingly, this legislative proposal caught the attention of the state regulators and their organization, the North American Securities Administrators Association (NASAA), which offered strong opposition to the legislation.⁹¹ Importantly, the SEC effectively refused to take a position on the matter. The testimony and prepared remarks of then-Chairman Levitt offered during the legislative hearings skillfully dodged any support for broad preemption of state authority over securities offerings.⁹²

⁸⁷ In the legislative hearings that led to NSMIA, then-Chairman of the SEC, Arthur Levitt, stated: "The current system of dual federal-state regulation is not the system that Congress—or the Commission—would design today if we were creating a new system." *Capital Markets Deregulation and Liberalization Act of 1995: Hearing on H.R. 2131 Before the Subcomm. on Telecomms. & Fin. of the H. Comm. on Commerce*, 104th Cong. 105 (1995) [hereinafter *Hearing*] (statement of Arthur Levitt). Nonetheless, Chairman Levitt in those hearings refused to endorse a broad preemption of state authority of securities offerings. See *infra* note 91 and accompanying text.

⁸⁸ See *supra* notes 66–80 and accompanying text.

⁸⁹ H.R. 2131, 104th Cong. (1st Sess. 1995).

⁹⁰ Section 3(a) of the Capital Markets Bill, *id.*, would have allowed continued state authority over offerings that were exempt from federal registration requirements under the intrastate exemption. The intrastate exemption is found at 15 U.S.C. § 77c(11) (2006).

⁹¹ See *Hearing*, *supra* note 87 (statement of Dee R. Harris, President, North American Securities Administrators Association) ("NASAA is opposed to the preemption of the state authority to register and review securities offerings.").

⁹² See *id.*

As a result, when the bill was finally signed into law as the National Securities Markets Improvement Act of 1996, the preemption, as originally proposed, was scaled back dramatically.⁹³

With regard to offerings under Regulation D, NSMIA preempted state authority only over Rule 506 offerings. States preserved their rights to regulate the sale of securities offered under Rule 504 and Rule 505.⁹⁴

This was disastrous for Regulation D and the Commission's balanced regulatory regime. It is the reason that roughly 80% of all offerings that are eligible to use Rule 504 or Rule 505 are now made, instead, under Rule 506 and limited to accredited investors. Rule 506 became the overwhelming choice for small issuers to avoid the dreaded clutches of state regulators.

Apparently, however, even this modest amount of preemption did not sit well with state regulators and those who favor state control over the registration of securities.

In 2009—thirteen years after NSMIA preempted state authority over Rule 506 offerings—Senator Christopher Dodd circulated a discussion draft of an approximately 1100-page bill, then entitled the Restoring American Financial Stability Act of 2009 (the Financial Stability Bill).⁹⁵ This bill would later become the core of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).⁹⁶ Buried in Senator Dodd's discussion draft were two provisions having nothing to do with our financial crisis but everything to do with small business capital formation. The provisions were a double-barreled assault on NSMIA's preemption of state authority over Rule 506 offerings.

⁹³ See Campbell, *The Insidious Remnants*, *supra* note 86 (arguing that the impact of state blue sky laws after NSMIA is both discriminatory against small businesses and substantively unsound).

⁹⁴ NSMIA preempts state authority over the registration of "covered securities." 15 U.S.C. § 77r(b)(1)(A) (2006) (amended 2012). "Covered securities" include securities offered by an issuer pursuant to "Commission rules or regulations issued under [section 4(2)]." *Id.* § 77r(b)(4)(D). Rule 506 was enacted under the Commission's authority in section 4(2). See 17 C.F.R. § 230.506(a) (2012). Securities offered under the exemption provided by section 3(b) of the Securities Act are not "covered securities" and thus not subject to preemption. 15 U.S.C. §§ 77c(b), 77r(b)(1)(A). Rule 504 and Rule 505 were enacted under the Commission's authority in section 3(b). See 17 C.F.R. §§ 230.504(a), 230.505(a).

⁹⁵ Restoring American Financial Stability Act of 2009 (Discussion Draft), S. Comm. on Banking, Hous. & Urban Affairs (2009) [hereinafter Financial Stability Bill].

⁹⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Section 928 of the Financial Stability Bill would have eliminated preemption of state authority over Rule 506 offerings.⁹⁷ Its impact would have been significant, especially on small businesses seeking external capital.

Consider in that regard data from Tables I, III and IV in Part III of this article. Table I shows that approximately 12,000 Rule 506 offerings are typically made each year,⁹⁸ and under the Financial Stability Bill all of those offerings would have become subject to the regulatory regimes of all fifty states. The impact on small issuers can be seen in Table III and Table IV. Table III shows that on average small issuers annually make more than 3500 Rule 506 offerings of one million dollars or less.⁹⁹ Table IV shows that on average small issuers annually make more than 3000 Rule 506 offerings of one million to five million dollars.¹⁰⁰ In sum, therefore, nearly 7000 small offerings per year would have lost the advantage of preemption and become subject to the regulatory regimes of fifty separate states.

The second prong of the assault on small business capital formation was in section 413 of the Financial Stability Bill. It would have required the Commission to raise both the income standard and net worth standard for accredited investor status under Regulation D so as to reflect "price inflation since those figures were determined."¹⁰¹ Because the net worth standard and the accredited investor standard go back to 1982,¹⁰² a rule that applied an inflation multiple to the standards would have significantly

⁹⁷ The Bill proposed to amend section 18 of the Securities Act, 15 U.S.C. § 77r, by eliminating securities offered under Rule 506 from inclusion in the definition of "covered securities." See Financial Stability Bill, *supra* note 95, § 928.

⁹⁸ Table I shows that over a 26-month period, there were approximately 25,500 Rule 506 offerings. That amounts to slightly fewer than 1000 Rule 506 offerings each month, or approximately 12,000 Rule 506 offerings per year. See *supra* Table I.

⁹⁹ Table III shows that over a 26-month period, there were 6196 Rule 506 offerings of one million dollars or less. That amounts to an average of 238 such offerings each month, or 2856 such offerings per year. See *supra* Table III.

¹⁰⁰ Table IV shows that over a 26-month period, there were 6487 Rule 506 offerings of one million to five million dollars. That amounts to an average of 250 such offerings each month, or 3000 such offerings per year. See *supra* Table IV.

¹⁰¹ The language of the bill was the following: "The Commission shall, by rule . . . increase the financial threshold for an accredited investor . . . by calculating an amount that is greater than the amount in effect on the date of the enactment of this Act . . . as the Commission determines is appropriate and in the public interest, in light of price inflation since those figures were determined." Financial Stability Bill, *supra* note 95, § 412(1). The bill went on to require the Commission to "adjust that threshold not less frequently than once every 5 years." *Id.* § 412(2).

¹⁰² 17 C.F.R. § 230.501(a)(6)-(7) (1982).

increased the thresholds and correspondingly reduced the total pool of investors that meet the criteria.¹⁰³

Section 413 seemed essentially to be a strategic back-up position designed to drive small businesses back under state control in the event Congress chose not to eliminate preemption over Rule 506 offerings. Thus, even if Congress refused to repeal the preemption over Rule 506 offerings, increasing the accredited investor thresholds would have effectively limited the number of accredited investors. With the number of potential investors significantly limited, it was likely that small businesses would to some degree abandon Rule 506 and return to the utilization of Rule 504 and Rule 505, thereby subjecting their offerings once again to state regulatory schemes.

Not surprisingly, commentators immediately concluded that state regulators, acting through NASAA, were behind these provisions designed to eliminate the preemption effects of NSMIA.¹⁰⁴

The strategy was formidable. Small provisions were buried in a huge, complex piece of contentious legislation, making it as a political matter difficult to eliminate the provisions from the Bill. Also, once again, the proponents correctly counted on the fact that the Commission would not interject itself into the legislative fray. The Commission, following the same path as it took during the NSMIA hearings, offered no support in favor of continued federal preemption of Rule 506 offerings.

Notwithstanding the formidable legislative strategy of the proponents, the two proposals originally in sections 928 and 413 of the Financial Stability Bill essentially were eliminated from the final version of the Dodd-Frank Act that was signed into law. The Dodd-Frank Act preserved the preemption of state authority over Rule 506 offerings.¹⁰⁵ With regard to increasing the thresholds for accredited investor status, the Act made no

¹⁰³ See *supra* notes 82–83 and accompanying text.

¹⁰⁴ See, e.g., Bill Carleton & Joe Wallin, *Dodd's Attack on Angel Financing*, VENTURE BLOG (Mar. 15, 2010, 1:15 PM), http://techflash.com/seattle/2010/03/congress_attack_on_angel_financing.html; Broc Romanek, *Dodd Bill Peculiarities: The SEC's Reg D Preemption Gets Hammered*, THECORPORATECOUNSEL.NET (Mar. 23, 2010, 9:09 AM), <http://www.the-corporatecounsel.net/Blog/2010/03/an-office-of-investor-advocate.html>; Scott Edward Walker, *A Personal Letter to Senator Dodd Regarding His Anti-Angel Investment Bill*, WALKER PLLC (Mar. 31, 2010, 2:53 PM), <http://walkercorporate-law.com/angel-issues/a-personal-letter-to-senator-dodd-regarding-his-anti-angel-investment-bill/>.

¹⁰⁵ The Act did impose so-called “bad boy” provisions on Regulation D offerings, which disqualify felons and others engaging in certain types of bad conduct from using Regulation D. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (2010) (to be codified at 15 U.S.C. § 77d).

change in the annual income test but amended the net worth test to exclude “the value of [the investor’s] primary residence.”¹⁰⁶ The Act froze the definition of accredited investor for four years.¹⁰⁷

B. Remedial Action(s)

The solution to the Regulation D dilemma is simple to articulate. In order to restore Regulation D to its appropriate place in the governance of small business capital formation, state authority over all Regulation D offerings must be eliminated. What is not so simple, however, is to identify the rulemaker that is willing to deal with the matter. It is with regard to this issue that the history of the relationship between state and federal regulators is important.

There are three possible rulemakers that could eliminate state authority over capital formation. First, states could surrender their authority over the registration of securities issued in Regulation D offerings. Second, the Commission could extend federal preemption through the exercise of its regulatory power. Third, Congress could extend preemption by the exercise of its legislative power.

What history demonstrates is that not only will states not surrender their authority over registration of Regulation D, but also they—more precisely, state securities regulators—will fight vigorously to expand their authority over Regulation D offerings and, indeed, over all securities offerings. History also shows that they are a formidable force, both in terms of their ability to control legislative outcomes, as they did in the legislation that became NSMIA, and in their willingness to employ tough political strategies, as they did with the legislation that became the Dodd-Frank Act. In short, there is little likelihood that states will ever voluntarily surrender their authority over Rule 504 and Rule 505 offerings.

The SEC has three options to eliminate state authority over Regulation D offerings. First, the Commission could amend Rule 504 and Rule 505 by changing the statutory basis for those rules. Rule 504¹⁰⁸ and Rule 505¹⁰⁹ are based on section 3(b) of the Securities Act, and NSMIA does not preempt state authority over securities issued under a regulatory exemption based on

¹⁰⁶ *Id.* § 413, 124 Stat. at 1577. The Commission recently proposed regulations to implement this statutory change. Net Worth Standards for Accredited Investors, *supra* note 81, at 5307.

¹⁰⁷ § 413, 124 Stat. at 1577.

¹⁰⁸ 17 C.F.R. § 230.504(a)(3) (2012) (offerings meeting the conditions of Rule 504 are “exempt from the Provisions of section 5 of the Act under section 3(b) of the Act”).

¹⁰⁹ *Id.* § 230.505(a) (offerings meeting the conditions of Rule 505 are “exempt from the provisions of section 5 of the Act under section 3(b) of the Act”).

section 3(b).¹¹⁰ NSMIA does, however, preempt state authority over securities offered or sold in a transaction exempt under “regulations issued under Section 4(2).”¹¹¹ By amending the basis for Rule 504 and Rule 505 to make them section 4(2) exemptions, state authority would be preempted for all offerings under Regulation D.

The second option for the Commission would be to use its delegated authority under NSMIA to expand preemption. NSMIA preempts state authority over offerings of “covered securities,” which include securities offered or sold to “qualified purchasers, as defined by the Commission.”¹¹² The broad breadth of the Commission’s authority to define “qualified purchasers” is made clear by the language of the statute itself, which limits the Commission’s authority only by requiring that the definition be “consistent with the public interest and the protection of investors.”¹¹³ Defining “qualified purchasers” to include purchasers of securities under Rule 504 and Rule 505 would meet the “public interest” criterion, since NSMIA itself requires the Commission, when acting in the public interest, to give due consideration to “capital formation.”¹¹⁴

The final option for the Commission would be to petition Congress for an expansion of NSMIA’s scope to include preemption over securities issued under regulations enacted under section 3(b) of the Securities Act.¹¹⁵

Regrettably, history shows an unwillingness on the part of the Commission to act in regard to expanding preemption of state authority over registrations. In both the legislative actions leading to NSMIA and to the Dodd-Frank Act, the Commission failed to advocate in favor of preemption.

While one may be sympathetic with the Commission’s reluctance to oppose state regulators—its partners in the battle against securities

¹¹⁰ See 15 U.S.C. § 77r(a)–(b) (2006).

¹¹¹ See *id.* § 77r(b)(4)(D) (amended 2012).

¹¹² See *id.* § 77r(b)(3).

¹¹³ *Id.*

¹¹⁴ Section 77b(b) requires that “[w]henever . . . the Commission engages in rulemaking and is required to consider or determine whether an action is . . . in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.” *Id.* § 77b(b).

¹¹⁵ This would be the preferred solution, since it would also preempt state authority over Regulation A offerings. See Campbell, *supra* note 53, at 106–10 (discussing the impact of blue sky laws on the availability of the exemption provided by Regulation A).

fraud¹¹⁶—the Commission's inaction has facilitated the severe damage done to Regulation D by blue sky laws and the actions of state regulators.

Not only has this inaction hurt small businesses, exacerbating their economic and structural disadvantages in the capital markets, but also the inaction seems inconsistent with the congressional delegation of authority under NSMIA. Congress in NSMIA expressed a clear preference for regulations that balance investor protection with the promotion of capital formation and expressly authorized the Commission to expand preemption by regulation.¹¹⁷ It is difficult, at least for me, to conclude that the Commission, in failing to act to expand preemption, is acting reasonably with regard to its delegated authority under NSMIA. It has the authority to act by regulation to bring investor protection and promotion of capital formation back into balance, yet it refuses to act.

Little can be said about the willingness of the third rulemaker, Congress, to expand preemption. Congress's taste for preemption seems to blow with the political winds, and it is difficult enough to understand the political winds of today, let alone predict the winds of the future. What is clear, however, is that the simplest and most efficient remedy here is a congressional remedy—a revision in NSMIA to take states entirely out of the regulation of the registration of securities.

VI. CONCLUSION

In Regulation D, the Commission crafted sensible exemptions from the registration requirements of the Securities Act. The regulation provided rules that appropriately and efficiently balanced the need for efficient capital formation with the need to protect investors, a balance that was later confirmed as obligatory by federal legislation. Regulation D specifically addressed the special capital formation needs of small businesses, a large and vital part of our national economy.

State blue sky laws, however, wrecked Regulation D. The data presented in this article demonstrate that entrepreneurs attempting to raise relatively small amounts of capital generally fail to avail themselves of the Regulation D rules specifically designed to meet their special situation.

¹¹⁶ In a prior article, I wrote about the reluctance of the Commission to expand preemption by regulation. Rutheford B Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175 (1997). Without expressing an opinion as to the actual motivation of the Commission, I offered various explanations for the Commission's inaction (e.g., fear of exceeding its delegated authority; preference for state rules over its own; failure to recognize the hegemonic realignment effected by NSMIA). *Id.* at 207–09.

¹¹⁷ See *supra* note 18 and accompanying text.

It now falls to the Commission or Congress to take steps to remedy this situation and reclaim Regulation D.

